www.mikevlasic.com

Liquidity in a World of Unusual Risk

Trading Liquidity for Yield in the Current Market is a Risky Choice

Mike Vlasic – April, 2015

The universe of negative yielding investments continues to expand, bolstered by the Big Bang of the European Central Bank's QE (Quantitative Easing). As a result, corporate borrowers are getting into act. The result is a risky, unpredictable investment environment.

What should a private, taxable, individual or family investor do? Of course avoiding negative yields is a high priority, but where does liquidity fit into the formula?

A major concern is that many investors who are looking for better yield are searching in very illiquid places. Private Equity is one of them, and there are some funds now that have 20-year terms, as opposed to the standard 10-year terms. Consider the fee drag. How can an investor make money paying upfront management fees on capital that has been committed but not invested for 5+years? The illiquidity of these funds has doubled.

From our past experience in 2007-2009, we also know that these illiquid investments became very burdensome for many investors, from individuals to families and even endowments. Let's not forget that the hedge funds everyone wanted so badly restricted withdrawals during this period, forcing many investors to sell better performing, but liquid, investments to fund cash requirements.

We also must take into account the fact that assets are expensive in the current investing environment. This is true across the board, with the exception of oil and gas. On an absolute basis real estate, equities, credit and fixed income are all costly assets.

Finally, and most importantly, we must seriously consider the uncertainty about the future. Governments are intervening in markets everywhere and at all levels. In addition to managing interest rates, we now have "macroprudential regulation" – financial regulation aimed at mitigating the risk of the financial system as a whole. If regulators really knew how to write rules to prevent bubbles and market dislocations, why didn't it work the last time? Also, negative yields could last a long time or inflation could start much sooner. We are starting to see increasing labor costs in the US, which we have been told is the real precursor to inflation.

What is our conclusion? Since assets are absolutely expensive and the future holds huge uncertainty, liquidity is more important than ever to avoid trapping investors in negative situations. Investors need liquidity for new investments if prices drop or if interest rates bounce up. They need cash flow if yields continue to be low, if a market dislocation occurs, to fund capital calls in illiquid investments and more.

Trading liquidity for yield in the current market is a risk not worth taking.

© 2015 Michael Vlasic. All rights reserved. May be referenced or reprinted with complete attribution to Mike Vlasic, www.mikevlasic.com